

(d) *Modifications*—(1) *Issue price*. The issue price of the loan or contract is equal to—

(i) In the case of a contract for the sale or exchange of property to which section 483 applies, the amount described in § 1.483-2(a)(1)(i) or (ii), whichever is applicable;

(ii) In the case of a contract for the sale or exchange of property to which section 483 does not apply, the stated principal amount; or

(iii) In any other case, the amount loaned.

(2) *Principal payments that are not deferred payments*. In the case of a contract to which section 483 applies, principal payments that are not deferred payments are ignored for purposes of determining yield and adjusted issue price.

(e) *Allocation of interest to payments*—(1) *In general*. Except as provided in paragraphs (e)(2), (e)(3), and (e)(4) of this section, each payment under a loan (other than payments of additional interest or similar charges provided with respect to amounts that are not paid when due) is treated as a payment of interest to the extent of the accrued and unpaid interest determined under paragraphs (b) and (c) of this section as of the date the payment becomes due.

(2) *Special rule for points deductible under section 461(g)(2)*. If a payment of points is deductible by the borrower under section 461(g)(2), the payment is treated by the borrower as a payment of interest.

(3) *Allocation respected in certain small transactions*. [Reserved]

(4) *Pro rata prepayments*. Accrued but unpaid interest is allocated to a pro rata prepayment under rules similar to those for allocating accrued but unpaid original issue discount to a pro rata prepayment under § 1.1275-2(f). For purposes of the preceding sentence, a pro rata prepayment is a payment that is made prior to maturity that—

(i) Is not made pursuant to the contract's payment schedule; and

(ii) Results in a substantially pro rata reduction of each payment remaining to be paid on the contract.

(f) *Aggregation rule*. For purposes of this section, all contracts calling for deferred payments arising from the

same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts involving a single borrower and a single lender.

(g) *Debt instruments denominated in a currency other than the U.S. dollar*. This section applies to a debt instrument that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S. dollar). See § 1.988-2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(h) *Example*. The following example illustrates the rules of this section.

Example. Allocation of unstated interest to deferred payments—(i) *Facts*. On July 1, 1996, A sells his personal residence to B for a stated purchase price of \$1,297,143.66. The property is not personal use property (within the meaning of section 1275(b)(3)) in the hands of B. Under the loan agreement, B is required to make two installment payments of \$648,571.83 each, the first due on June 30, 1998, and the second due on June 30, 2000. Both A and B use the cash receipts and disbursements method of accounting and use a calendar year for their taxable year.

(ii) *Amount of unstated interest*. Under section 483, the agreement does not provide for adequate stated interest. Thus, the loan's yield is the test rate of interest determined under § 1.483-3. Assume that both A and B use annual accrual periods and that the test rate of interest is 9.2 percent, compounded annually. Under § 1.483-2, the present value of the deferred payments is \$1,000,000. Thus, the agreement has unstated interest of \$297,143.66.

(iii) *First two accrual periods*. Under paragraph (d)(1) of this section, the issue price at the beginning of the first accrual period is \$1,000,000 (the amount described in § 1.483-2(a)(1)(i)). Under paragraph (c) of this section, the amount of interest that accrues for the first accrual period is \$92,000 ($\$1,000,000 \times .092$) and the amount of interest that accrues for the second accrual period is \$100,464 ($\$1,092,000 \times .092$). Thus, \$192,464 of interest has accrued as of the end of the second accrual period. Under paragraph (e)(1) of this section, the \$648,571.83 payment made on June 30, 1998, is treated first as a payment of interest to the extent of \$192,464. The remainder of the payment (\$456,107.83) is treated as a payment of principal. Both A and B

take the payment of interest (\$192,464) into account in 1998.

(iv) *Second two accrual periods.* The adjusted issue price at the beginning of the third accrual period is \$543,892.17 (\$1,092,000+\$100,464-\$648,571.83). The amount of interest that accrues for the third accrual period is \$50,038.08 (\$543,892.17×.092) and the amount of interest that accrues for the final accrual period is \$54,641.58, the excess of the amount payable at maturity (\$648,571.83), over the adjusted issue price at the beginning of the accrual period (\$593,930.25). As of the date the second payment becomes due, \$104,679.66 of interest has accrued. Thus, of the \$648,571.83 payment made on June 30, 2000, \$104,679.66 is treated as interest and \$543,892.17 is treated as principal. Both A and B take the payment of interest (\$104,679.66) into account in 2000.

(i) [Reserved]

(j) *Effective date.* This section applies to debt instruments issued on or after April 4, 1994, and to lending transactions, sales, and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for debt instruments issued after December 21, 1992, and before April 4, 1994, and for lending transactions, sales, and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994]

§ 1.446-3 Notional principal contracts.

(a) *Table of contents.* This paragraph (a) lists captioned paragraphs contained in § 1.446-3.

§ 1.446-3 Notional principal contracts.

- (a) Table of contents.
- (b) Purpose.
- (c) Definitions and scope.
 - (i) Notional principal contract.
 - (i) In general.
 - (ii) Excluded contracts.
 - (iii) Transactions within section 475.
 - (iv) Transactions within section 988.
 - (2) Specified index.
 - (3) Notional principal amount.
 - (4) Special definitions.
 - (i) Related person and party to the contract.
 - (ii) Objective financial information.
 - (iii) Dealer in notional principal contracts.
 - (d) Taxable year of inclusion and deduction.
 - (e) Periodic payments.
 - (1) Definition.
 - (2) Recognition rules.
 - (i) In general.
 - (ii) Rate set in arrears.
 - (iii) Notional principal amount set in arrears.

- (3) Examples.
- (f) Nonperiodic payments.
 - (1) Definition.
 - (2) Recognition rules.
 - (i) In general.
 - (ii) General rule for swaps.
 - (iii) Alternative methods for swaps.
 - (A) Prepaid swaps.
 - (B) Other nonperiodic swap payments.
 - (iv) General rule for caps and floors.
 - (v) Alternative methods for caps and floors that hedge debt instruments.
 - (A) Prepaid caps and floors.
 - (B) Other caps and floors.
 - (C) Special method for collars.
 - (vi) Additional methods.
- (3) Term of extendible or terminable contracts.
- (4) Examples.
- (g) Special rules.
 - (1) Disguised notional principal contracts.
 - (2) Hedged notional principal contracts.
 - (3) Options and forwards to enter into notional principal contracts.
 - (4) Swaps with significant nonperiodic payments.
 - (5) Caps and floors that are significantly in-the-money. [Reserved]
 - (6) Examples.
 - (h) Termination payments.
 - (1) Definition.
 - (2) Taxable year of inclusion and deduction by original parties.
 - (3) Taxable year of inclusion and deduction by assignees.
 - (4) Special rules.
 - (i) Assignment of one leg of a contract.
 - (ii) Substance over form.
 - (5) Examples.
 - (i) Anti-abuse rule.
 - (j) Effective date.

(b) *Purpose.* The purpose of this section is to enable the clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts.

(c) *Definitions and scope*—(1) *Notional principal contract*—(i) *In general.* A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter